

## **PRESIDENT’S ADVISORY COUNCIL ON FINANCIAL LITERACY**

### **STATEMENT OF PRINCIPLES AND RECOMMENDATIONS FOR THE FUTURE OF SUB-PRIME MORTGAGE LENDING**

#### **Introduction**

In Executive Order 13455, signed on January 22, 2008, President George W. Bush created the first-ever President’s Advisory Council on Financial Literacy. Among the responsibilities of the Council is to “advise the President and the Secretary...on the means to promote effective access to financial services, especially for those without access to such services.” To be responsive to that charge, the Council created a Committee on the Underserved, chaired by Council Vice Chairman John Hope Bryant, to explore ways to improve access to financial services for the underserved and the unbanked. One area which the Committee has chosen to explore is sub-prime mortgage lending.

With all the attention focused over the past year on the subprime mortgage crisis, there is increasing concern that lending to potential homeowners may dry up, which would not be a positive development for increasing homeownership among all citizens. The Council recognizes that subprime mortgage lending has had a positive benefit on giving Americans the opportunity to own their own home. There is also widespread agreement that a lack of financial literacy is particularly acute among the population most likely to utilize subprime lending opportunities, and that this lack of financial literacy has been a critical contributing factor to the current crisis.

To explore ways in which subprime lending might be encouraged in the future, the Underserved Committee, a subgroup of the President’s Advisory Council on Financial Literacy convened, on May 28, 2008, a group of expert advisors, representing government agencies, community development organizations, research groups, and lenders. Among the goals of the meeting was to identify what financial literacy initiatives would be needed to address the massive level of financial illiteracy that has been a key contributor to the recent crisis.

Members of the Committee led a rich, vigorous discussion that focused on various aspects of the lending process. The meeting produced numerous excellent ideas from a variety of sources. The Committee then drafted a report outlining the best ideas that were produced by the group during the meeting.

At its meeting on June 18, 2008, the Council began its review of the Committee’s recommendations, and formally approved the Committee’s recommendation that financial literacy must be the foundation of the future of responsible subprime lending.

#### **Recommendations**

The Council endorses the idea that a subprime lending product should continue to be available in the marketplace. Subprime mortgage lending should continue to play a critical role in giving certain borrowers, such as first-time homebuyers and those with imperfect credit records, the

opportunity to become homeowners. To that end, the Council agrees that three overarching principles must form the basis of subprime lending:

- 1) Financial literacy must be at the foundation of all subprime lending.
- 2) A key goal of all subprime lending must be to move subprime borrowers to prime borrowers.
- 3) Lending products should have straightforward disclosures and be understandable to the consumer.

The Council further endorses the following general principles, which emphasize the importance of financial education as a core part of the lending process.

*Making Financial Literacy a Cornerstone of Subprime Borrowing:*

- Lenders and borrowers must recommit to the idea that financial literacy is a critical component of the loan process. Therefore, it is recommended that either every borrower demonstrate an understanding of the terms of the loan or the borrower complete a basic course in homeownership education from an accredited program that is not affiliated with the lender prior to signing the loan documents. The course should include, at a minimum, information on mortgages, mortgage terms, debt management, budgeting, credit scores and the impact of missed payments on those scores, savings and emergency funds, cost and obligation of home ownership, and money management.
- It is recommended that the Outreach Committee, a subgroup of the President's Advisory Council on Financial Literacy investigate what mechanism might be appropriate for accrediting programs to meet this need.
- A simplified disclosure of terms must be delivered to the borrower early in the process and at the end of the process the borrower should acknowledge his or her understanding of the disclosure. This disclosure should be in plain English, with a minimum of legalese or difficult terminology. Where such terminology is unavoidable, a plain-English explanation of the term must be provided. This simplified form should include, at a minimum:
  - The interest rate on the loan;
  - The term of the loan, in months and years;
  - The total amount of the loan;
  - An estimate of the closing costs;
  - The total amount of funds needed to cover principal, interest, taxes and insurance at closing;
  - An acknowledgement that the borrower understands that his/her income and assets will be verified by the lender;
  - The monthly payment, with and without property taxes and insurance;
  - The down payment amount;
  - Highest possible monthly payment under the terms of the loan, in dollars;

- Disclosure of all credit scores;
  - Detailed explanation of any changes in the interest rate or monthly payment that are built into the loan, and the date such changes take effect;
  - An explanation of how the lender determined whether the borrower has a reasonable chance of paying back the loan; and
  - The availability, both pre-purchase and post-purchase, of financial counseling.
- Financial education should be done face-to-face, or, if that is not possible, over the telephone or Internet.
  - Financial education resources and contacts should be listed and provided at all points of the mortgage process and in all mortgage materials.
  - Most importantly, every participant in the mortgage process should encourage a subprime borrower to become a prime borrower. By establishing the lender/borrower relationship as a “service” model, rather than a “transaction” model, originators, brokers, and servicing representatives would be encouraged to follow best practices that place the interests of the borrower first.

### **Conclusion**

The Council concludes that:

- 1) Subprime lending plays an important role in making home ownership opportunities available to all citizens and should continue to be available in the marketplace;
- 2) Financial literacy must be at the foundation of all lending, both subprime and prime, and that financial education must be made available to the borrower both at the beginning of the loan process and throughout the life of the loan;
- 3) Simplified disclosure documents must be offered to all subprime borrowers, explaining key terms in plain English; and
- 4) All participants in the lending process should follow practices that reduce conflicts, reward service over transaction volume, and keep the best interests of the borrowers at the forefront at all times.

### **Action Item**

That the Council recommends that the U.S. Department of the Treasury adopt the *Statement of Principles and Recommendations for the Future of Sub-Prime Mortgage Lending*.